

APPENDIX

NOTES FOR FOMC MEETING
MAY 18, 1982

Margaret L. Greene

The predominant tendency in the exchange markets since your last FOMC meeting--and especially after mid-April--was for the dollar to move lower. For 3 1/2 weeks the dollar declined almost without interruption, dropping as much as 6 percent against the German mark and Japanese yen at one point. But then bursts of short covering in recent days have pushed the dollar back up. As of this morning the dollar is still down on balance in most markets. It is off about 3 1/2 percent against the mark and the yen and down about 1 percent against sterling. But it is up slightly against the Canadian dollar and higher by about 2 percent against the Swiss franc. Since the dollar was initially trading at relatively firm levels, this decline was not a matter of concern and may well have been welcomed in some centers. But it did coincide with some lessening of the bullish market sentiment for the dollar in several respects. It is hard to judge at this stage whether this change in nuance will prove transitory or more permanent.

For several months, the market expected that U.S. interest rates might remain firmer than is customary during recession and, when they eventually decline, central banks in other countries would be ready to see interest rates in their markets decline in line. But the dollar's decline began as this expectation started to shift. After mid-April continuing evidence of weak economic activity in the U.S., expectations that the April bulge in M_1 would prove temporary and

unrealistic assessments about the progress towards bringing the U.S. budget deficit under control generated a feeling that interest rates in the U.S. might drop--and drop quite sharply. Meanwhile central banks in other countries except Switzerland were seen as being more cautious about proceeding to ease money market conditions at home. This was either because of concern about prospective injections of liquidity--the Bundesbank was about to transfer DM 10 billion of last year's profits to the government--concern about the continued weakness of their currencies, or reluctance to allow their currencies to be any more exposed to pressures in the face of heightened political tensions abroad, especially in the South Atlantic.

For more than a year, the dollar has been viewed as a safe haven for investment at times of trouble abroad. But in this respect also the dollar's attraction eroded somewhat as the Falkland Islands conflict dragged on. Not only was the U.S. government unable to head off a military conflict there. It also had to forego a stance of neutrality, thereby complicating U.S. relationships with Latin America and the Administration's efforts to contain Soviet influence in the western hemisphere. Since then, there have been recurring reports that some Latin American investors are concerned that the U.S. might come to the aid of our ally by assisting in Britain's freeze of Argentinian assets. On the domestic front, the growing frustration over the budget problem was also having some impact on the market's assessment of the Administration's effectiveness.

Moreover, the dollar had benefitted during the past year or more from the problems of other major currencies, and this too began to change during the inter-meeting period.

The outlook for the German mark has clearly improved. Germany's success in curbing inflation was underscored by a moderate 4 percent wage settlement with the pace-setting metal worker's union. Then, publication of a record postwar monthly trade surplus for March more than offset the disappointment over figures for earlier months and helped confirm expectations that Germany's current account would show considerable strengthening this year. These developments put the mark on a firmer footing, and by early May gave the Bundesbank scope to ease monetary conditions again. Even as the German central bank eliminated its special Lombard credit facility on May 6 and reintroduced its regular Lombard facility at a rate of 9 percent, 1/2 percentage point lower than the special Lombard rate, the mark did not weaken in the exchanges.

The yen was defended more vigorously by the authorities. Through moral suasion and administrative measures, they discouraged long-term capital outflows. They intervened forcefully in the exchange markets. In addition, the Bank of Japan operated fairly aggressively to push up short-term rates, even though interest rates in real terms were already high and the authorities are relying more on monetary than on fiscal policy to provide the needed stimulus to the domestic economy.

As for sterling, the immediate nervousness that surrounded the Falkland Islands crisis was quickly contained. It soon became clear that the current government was still in control. Also, the market pressures were quickly blunted through foreign exchange intervention and domestic operations to maintain a liquidity shortage.

The generalized decline in the dollar masked to some degree the continued weakness of several other currencies. There still was considerable concern about the countries where, for one reason or another, progress in curbing inflation is lagging behind. Within the EMS, the mark set a pretty fast pace for the other currencies, and some \$6 billion of intervention was conducted--in dollars and other currencies--to support the French franc, Italian lira, and Belgian franc. Closer to home, recession has not been accompanied in Canada by any significant easing of cost and price pressures. In this environment concern came to the surface last week after publication of a sharp increase in unemployment that political pressures would force the Canadian government to shift the focus of its economic policies from curbing inflation to stimulating the economy. As a result, the Canadian dollar came under pressure for several days, prompting heavy intervention by the Bank of Canada. All in all, foreign central banks sold more than \$7 billion net since end March.

On another front, the situation in Mexico continues to warrant attention. Although the Mexican government announced a stabilization program late in April that appears to establish a framework for better policies, the immediate market reaction did not allow the Bank of Mexico to restore its foreign exchange position. Consequently, that Bank requested a \$600 million drawing over the month-end on its swap line with the Federal Reserve to assist in meeting its legal requirement with respect to international reserves held against note issue. After consultation with the Bank of Mexico and review by members of the Committee, the request was granted and the drawing was subsequently repaid as scheduled on May 3.

NOTES FOR FOMC MEETING
MAY 18, 1982

PETER D. STERNLIGHT

Desk operations since the March 30 meeting were shaped by monetary aggregates that exceeded path through about the first half of April, and then abated to levels about on or a little below path in late April and early May. The reserve path was based on a substantial 9 percent growth rate for M1 in April, to be followed by no growth in May and June, but early April growth in M1 pushed up even beyond the rate allowed. Even after some of the bulge washed out late in the month the April growth rate was nearly 12 percent.

Reflecting the bulge, total reserves in the first four-week subperiod, ended April 28, were \$160 million above path. Nonborrowed reserves, meantime, averaged about \$55 million below their path in those weeks. The shortfall was partly attributable to a scarcity of collateral that impeded the Desk in providing reserves late in the April 28 week when Treasury balances were exceptionally high. Largely because of the strong demand for reserves, average borrowing pushed some \$215 million above its path level, and the implicit borrowing gap in the latter weeks of the first subperiod rose to about \$1.4 billion.

In the second subperiod, the three weeks ending May 19, demand for reserves abated as money growth returned to path or a bit below. At last look, it was estimated that demand for

reserves would be about \$35 million below path for the three weeks, implying average borrowing slightly below the Committee's initial \$1,150 million level. The implicit borrowing gap in this final week of the subperiod is about \$1,045 million. At this point, we expect nonborrowed reserves for the second subperiod to be close to path.

Notwithstanding the upward push, and then abatement, in borrowing pressures, Federal funds showed little trend over the intermeeting period, largely moving in a 14 1/2 - 15 1/2 percent range--roughly the same as in the latter half of March. On the basis of past rough relationships, one might have expected a funds rate closer to 14 percent or a little lower in association with borrowing of around \$1 billion and a discount rate of 12 percent. Possibly, the funds rate has been sluggish in receding, as borrowing levels came down, because after an extended period of fairly high borrowings a number of banks felt constrained to be more sparing in their use of the discount window--but this is conjectural.

For much of the period, day-to-day operations were dominated by the need to cope with the reserve effects of a huge run-up in Treasury balances at the Federal Reserve. Ordinarily, the Treasury strives to keep its working balance at the Fed fairly constant around \$3 billion, using commercial bank tax and loan depositories to absorb the fluctuations in

their total cash balance. With the capacity of those commercial bank depositories limited to about \$17 billion, however, a post-April 15 tax date bulge in total Treasury balances to nearly \$30 billion meant that the Fed balance soared to more than \$12 billion in late April, absorbing reserves in the process. Currency outflows, including sizable note shipments to Argentina, and higher required reserves added to the reserve need.

The Desk used a combination of outright purchases and repurchase agreements to meet the large reserve need. Purchases of bills and Treasury coupon issues, both in the market and from foreign accounts reached nearly \$5 billion by late April, requiring a substantial increase in the normal \$3 billion intermeeting leeway for change in outright holdings. While it turned out that we did not actually use any of the final \$1 billion increase in leeway approved by the Committee we came within about \$20 million of needing some of it, so its availability was a useful safety margin. Later in the period, the System sold or redeemed about \$900 million of bills so the net increase in outright holdings was a little over \$4 billion. The outright activity was supplemented by temporary transactions, including a record one-day volume of RP's arranged on April 29--roughly \$8.7 billion.

The Treasury, along with the Federal Reserve Banks, has been actively exploring ways to enlarge the tax and loan holding capacity at commercial banks. Thus, I'm optimistic that future reserve management problems due to swollen Treasury balances can be reduced.

Most market interest rates declined moderately over the period since the last meeting. The market was buoyed by continuing signs of recession and progress in curbing inflation, but concern about budget deficits and money growth tended to limit the rate declines. Indeed, the counterbalancing of plus and minus forces was such that the market displayed rather muted responses to developments that might have been expected to elicit greater reaction. The uncertain fate of a budget compromise, while still much discussed, seemed to leave market participants bemused. My impression is that they lack conviction that there will soon be a meaningful compromise, but they also cannot believe there won't be enough progress to avoid the huge out-year deficit numbers associated in the press with no compromise agreement.

The April money bulge was taken fairly well in stride, having been anticipated and associated with problems of seasonal adjustment or other temporary factors. Some concern developed in the latter part of April, in the wake of higher borrowing levels and firm money markets, that the System might be making a tightening move, but there was also a view that these developments were merely results of technical problems because of high Treasury balances. By early May, with net borrowed reserve positions reduced and the April money bulge visibly unwinding, most

observers appeared to conclude that the System hadn't really tightened in April, or if they had, there had been a subsequent relaxation. At present there seems to be some sense among market participants that funds rates have recently been "higher than they ought to be". The market has probably discounted a decline in funds to about 14 percent, or a little under.

On balance over the interval, Treasury coupon issues were down about 40-75 basis points in yield. The Treasury raised about \$7 1/2 billion of new funds in coupon issues over the interval--including nearly \$3 billion in the mid-May quarterly refunding. The three and ten-year notes sold in that refunding were very well bid for in early May and rose to sizable premiums by yesterday's payment date for the issues. I should add that the market took on a heavier cost yesterday afternoon as stories spread about a relatively new and aggressive Government securities dealer having difficulty in meeting its commitments. This is a potentially serious situation and we will be following it closely.

Yields also declined in the bill area--by about 80-110 basis points. Three- and six-month issues were sold yesterday at about 12.19 percent, on each issue, respectively, down from about 13.40 and 13.24, respectively, just before the late March meeting. Since that time, the Treasury has paid down

a modest amount of bills--a counterpart to the seasonally heavy tax receipts at this time of year. While continuing to add to 12-month bills, they paid down some weekly bills and cash management bills. The flush cash position will last only through June, after which the Treasury will undoubtedly have to be a heavy net taker of funds in the bill market as well as in coupons.

Rates on corporate issues came down about as much as Treasury coupon issues while domestic new issue volume was quite moderate. Eurodollar issues are sizable, though. Reports persist of a large backlog of domestic issues ready to be sold if rates drop further. While many participants seem to believe there will be further rate declines in the next month or two, there is also a widespread view that fresh increases could be seen later in the year, so one wonders that more issuers don't avail themselves of whatever bit of a window may be showing now. Perhaps some are using the Eurodollar financing route instead.

In the tax exempt sector, rate declines were more pronounced than for Treasury or corporate issues--apparently spurred by heavy demand from both institutions and individuals, much of the latter through bond funds. This relatively strong performance, with yields down better than 1 percentage point, tends to make up for the weaker showing of this market in late 1981 and early '82. New issue volume has been substantial.

Finally, the Braniff bankruptcy seems to have had little general impact on the financial markets. The company's problems were well known and last week's events, while not precisely foreseen as to timing, essentially came as no great surprise. We have not observed a general "flight to quality" or sudden shying away from other credits deemed to have some questionable element. Lenders do remain cautious, though, and worry about the unexpected adversities that may lurk around the corner. Especially, there is concern that long-term persistence of high rates could push many other businesses over the edge.

James L. Kichline
May 18, 1982

FOMC BRIEFING

Economic activity early this quarter continued to decline and indeed much of the information available since the last meeting of the Committee has pointed to further weakness. But there have been some encouraging developments, especially in regard to consumer demands and the state of inventory liquidation. The staff's forecast continues to envisage a trough in activity this spring followed by moderate growth through 1983, while the rate of inflation on average is expected to show further improvement.

Key information on the continued contraction of activity in April came from the reports on employment and production. Nonfarm payroll employment declined 200,000 in April; employment in manufacturing fell somewhat less than in other recent months, although hiring at construction and trade establishments was considerably weaker than earlier. The unemployment rate in April rose 0.4 percentage point to 9.4 percent; initial claims for unemployment insurance since the April labor market survey was taken have edged down but at more than $\frac{1}{2}$ million per week suggest a further increase in unemployment.

Industrial production last month declined 0.6 percent and was $8\frac{1}{2}$ percent below the recent peak in July 1981. Output of consumer goods and defense equipment increased while most other major categories registered further declines. Automobile

production picked up from the dismal levels in the first quarter and this contributed importantly to the rise in output of consumer goods. For business equipment, the information from the industrial production index was decidedly bearish with output falling $1\frac{1}{2}$ percent in April and significant downward revisions for the preceding two months. Moreover, the recent drop was widespread, including building and mining equipment, machinery, and office and store equipment.

The performance of production and employment over the past half year is largely a reflection of business efforts to adjust to lower than expected final demands and bring down their inventories. In the first quarter inventories ran off at a huge \$40 billion annual rate, with roughly half of that attributable to autos and trucks. The motor vehicle adjustments appear to be largely behind us, but inventory/sales ratios suggest that further liquidation in other sectors is likely; the staff's forecast for the current quarter contains a sizable reduction of stocks, although smaller than the quarter earlier. In fact, the flat or slightly positive real GNP growth expected this quarter is entirely dependent on the inventory sector since final demands are projected to decline.

The consumption sector is the only major area of final demand in the forecast expected to show an increase in real terms this quarter, and it's a small rise. Consumer spending has held up quite well on average, although to support spending consumers cut into their saving rate last quarter. Retail sales data for

April became available after the forecast was prepared but they are consistent with our assumptions, rising about $\frac{1}{2}$ percent in nominal terms excluding autos and nonconsumer items. Unit sales of autos dipped in April following the end of sizable purchase incentive programs although they picked up again early this month. On balance, we still anticipate the midyear tax cut and social security benefit increase to lead to a considerable strengthening of consumer demands in the second half of the year, in effect leading the economy into recovery.

The fixed investment sector--including both housing and business investment--is the area of the forecast that has been revised downward appreciably since the last forecast. A part of that revision reflects some further weakening of the already poor prospects for real estate activity this year; we have adjusted to incoming data although the fundamental forces at work are not different from those operating for some time. But the business fixed investment sector is a different matter. Production, orders, contracts and other quantitative and qualitative evidence suggest a considerable deterioration in capital spending is in process. We revised real business fixed investment spending downward and it now declines 7 percent during 1982 and rises only a little next year. Even after the revision, however, the severity of balance sheet constraints and the apparent erosion of business confidence seems to place the risk of error on the down side.

Overall, the staff's forecast of real GNP has been reduced marginally during the forecast period and remains one

characterized by a near-term bottom in the recession and a moderate recovery over the next six quarters. This forecast retains the assumption that about half of the President's original budget deficit reducing measures will be adopted by the Congress. The recent actions in the Congressional Budget Committees do not clarify the likely ultimate program that may be adopted, and we have simply retained our previous assumption.

To end on an encouraging note, the incoming information on wages and prices continues to be very good. Although we could soon begin to see somewhat higher figures on the consumer and producer price indexes, given the probable stabilizing of petroleum prices and higher meat prices, we seem to be on track for a GNP deflator increase of under 6 percent this year, more than 3 percentage points below the rate last year.

FOMC Briefing
S. H. Axilrod
May 18, 1982

With M2 in the last few weeks probably coming out close to the 3-month path adopted by the Committee at its last meeting, and M1 running below that path--thus coming back toward its long-run range more promptly than targeted--the Committee would appear to have so far this spring avoided the strange, or unusual, dilemma that would be posed by continued high money growth during a recession. Of course, short-term interest rates have declined only modestly since the last meeting, and longer-term rates too have shown only quite modest drops, despite an apparent eagerness on the part of market participants to believe a strong rally may be at hand at any moment. As a result, so-called real interest rates have remained high despite recent very good price performance.

The level of real rates may be explained in part by still remaining fears of a resumption of inflation once the recovery begins; by the demand for a higher risk premium on longer-term securities, purchases of which in the past few years have been subject to an unexpected run of losses; by budgetary uncertainties; and by a relatively taut monetary policy. While the staff's maximum likelihood forecast is for only a slight further drop of interest rates over the months ahead, in part because we are expecting an increase in economic activity and nominal GNP, there are some grounds for a bit more optimism about rates, always assuming a reasonable degree of fiscal responsibility.

Our projection for nominal GNP growth for the year 1982 (QIV to QIV) is now down to just about 6 percent. This implies a small velocity increase against the M1 target for the year and a declining velocity against

the M2 target. Such outcomes would not be inconsistent with a declining trend of interest rates. It is difficult to read the entrails of various money demand equations. However, while the conventional quarterly model of the Board suggests a small downward shift in demand is still needed over the year to accommodate minor drops in bill rates from current levels, other models--based on different functions or fit over different time periods--would seem to allow more scope for a decline of interest rates.

Of course, no matter which model over which time period you look at, any interest rate decline still requires a considerable damping of the strong liquidity demands of early this year, and probably some unwinding of them--that is, a willingness to spend out of accumulated cash balances. In that connection, the hoped for slowing in growth of the OCD component of M1 was not evident until late April and early May. But whether that heralds a sustained lower trend is not clear since tax collections apparently lowered the late April number, and May, if last year is any guide, could have a somewhat distorted seasonal tending to depress estimated growth.

Recent econometric work by the staff seems to help confirm the view that the strong OCD growth of early this year was related to precautionary demands. A cross-sectional econometric study of banks for January of this year did not indicate--as it did early last year--that the growth in NOW accounts could be explained in any significant way by

declines in demand or savings deposits; rather, the growth in NOW accounts was associated with expansion, not contraction, in demand and savings accounts. Another piece of econometric work has shown that part of the increase in savings accounts, and by extension NOW accounts, can be explained by the unemployment rate--which adds some weight to the precautionary explanation--and another part by the decline in market rates relative to the rate on savings accounts. The partial results we have received so far from a special Michigan survey on attitudes toward, and use of, NOW accounts are not inconsistent with these results.

While there are bits and pieces of evidence which suggest that a modest economic recovery can be accomplished without further upward rate pressures, and that indeed downward pressures could emerge, there is always the risk that the monetary targets may bind too tightly for both interest rates to decline and the economy to recover in a reasonably satisfactory way. That could occur of course if the rate of inflation reaccelerated considerably, in which case the longer-run monetary targets might be considered to be appropriately binding. But the targets might bind in perhaps a less appropriate way if given the staff's fairly benign price outlook, precautionary money demands remained strong and/or if shifts out of cash into, say, sweep accounts did not take place in any significant way.

Taking account of the various possibilities with regard to money demand, and further assuming that price pressures will be generally contained, the Committee may wish to consider--so long as M2 is reasonably on path--whether underlying economic factors might not suggest the need to tolerate a fairly strong M1 performance. Such a performance might be

needed at a minimum to keep nominal interest rates from rising in a period of weak economic activity and reduced inflation, or even to encourage declines in nominal rates that might act as a spur to real spending.

Of course, M1 recently has tended to weaken. Should it continue to do so relative to adopted short-run paths, the Committee might also want to consider whether the weakness should not be relatively aggressively offset--so long as M2 is on track. One's judgment about that would depend in part on whether the weakness is perceived to represent a much greater downward demand shift than was anticipated, in which case a less aggressive posture would be warranted. However, should a curtailment in Federal spending or unanticipated weakness in private sectors limit aggregate demand for goods and services, a relatively substantial drop in nominal and real interest rates might well be needed to sustain economic recovery, particularly if and as it needed to depend more on private rather than public sector behavior.